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In the Supreme Court of the United States

OCTOBER TERM, 1980

GERALD R. REDDING, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners seek review of the decision below in this federal income tax case holding that they received a taxable dividend, when the Indianapolis Water Company distributed marketable warrants to them entitling them to buy stock of a subsidiary corporation (Shorewood) at less than the full fair market value of the Shorewood stock.

The pertinent facts are undisputed and may be summarized as follows: Shorewood Corporation, which was engaged in real estate development, was a wholly-owned subsidiary of the Indianapolis Water Company. The Indiana Public Service Commission took the position that real estate development was not an appropriate activity for a public utility such as the Water Company (Pet. App. A-2 to A-3). As a result, the Water Company's directors decided to

"spin-off" Shorewood, and further contemplated to increase Shorewood's capital at the same time. To this end, it was decided that Water Company shareholders would receive transferable warrants entitling them to purchase Shorewood stock at a bargain price of $5.00 per share plus two warrants. During the subscription period, Shorewood stock ranged in value from $5.70 to $7.00 per share (Pet. App. A-3, A-36). The warrants, which had to be exercised within a 15-day period, were actively traded, at prices ranging from 39 cents to $1.06 (Pet. App. A-3 to A-4, A-35). Water Company shareholders who did not want to put additional capital into Shorewood could sell their warrants to others, including non-shareholders, who were willing to put up additional capital (Pet. App. A-3 to A-4).

Petitioners were substantial shareholders of the Water Company and exercised all their warrrants to purchase Shorewood stock. They maintained that the distribution of warrants should be treated as merely a transitory step in a tax-free "spin-off," within the meaning of Section 355 of the Internal Revenue Code of 1954 (26 U.S.C.), which requires, *inter alia*, that the distributing corporation distribute stock or securities of the controlled corporation in an amount sufficient to constitute "control," which is defined in Section 368(c) to mean 80% of the voting stock (Pet. App. A-4 to A-5).[1] On audit, the Commissioner contended that the distribution of warrants should be treated as an independent taxable event, and not as a distribution of stock or

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[1]The amount of Shorewood stock to be sold to warrant holders was 1,069,537 shares, or 80% plus one share. Although the Commissioner stipulated (see Supp. App. A, at 10 to appellee's brief in the court of appeals) that, "[t]he 1,069,537 shares of Shorewood stock that were distributed on the Date of Distribution by the Water Company constituted more than 80% of the total number of shares of the only class of outstanding shares of Shorewood stock, and represented control of Shorewood, as defined in *Int. Rev. Code of 1954*, § 368(c)," some 50,000 of those shares were distributed to underwriters rather than to Water Company shareholders (Pet. App. A-20). Thus, although the language of the stipulation is concededly ambiguous, it seems clear that the

securities under Section 355.[2] In this suit brought by petitioners for redetermination of the ensuing deficiences, the Tax Court held that the transaction qualified as a tax-free spin-off under Section 355 (Pet. App. A-31 to A-57). The court of appeals reversed (Pet. App. A-1 to A-29). In upholding the Commissioner's position, the court emphasized that the use of the warrants was intended to permit Water Company stockholders to opt *out* of the purchase of Shorewood stock, rather than to be included *in* the Shorewood purchase, while raising cash for Shorewood's operations (Pet. App. A-11, A-12).

1. The decision below correctly held that the transaction did not qualify for tax-free treatment under Section 355. In substance, those shareholders who sold their warrants received an immediate cash benefit in return for giving up their interest in Shorewood, while Shorewood received the additional capital it needed when the warrant holders purchased stock. Thus, far from constituting a mere "procedural device" to facilitate distribution of Shorewood stock to

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transaction at issue failed to comply with the requirements of Section 355(a)(1)(D), because the percentage of the stock distributed to the Water Company shareholders amounted to, at most, 76.26% of all Shorewood shares (Pet. App. A-20). However, the court of appeals declined to address this argument on the belief that it was foreclosed by the stipulation (see Pet. App. A-20 to A-21).

[2]Treasury Regulations on Income Tax, Section 1.355-1(a) (26 C.F.R.) provides that stock warrants are not "stock or securities" for purposes of Section 355. Petitioners at no point have challenged the validity of this regulation. Rather, petitioners' case is premised on treating the warrants as an insubstantial intermediate step leading to the eventual distribution of Shorewood shares.

Water Company shareholders, the distribution of warrants conferred an independent economic benefit, and permitted Water Company shareholders to elect to take an immediate cash payment in lieu of exercising their warrants (Pet. App. A-11). In these circumstances, the court of appeals properly refused to characterize the arrangement as a "step transaction" so as to combine the warrant distribution with the purchase of Shorewood stock (Pet. App. A-11 to A-12). Instead, it ruled that Section 355 did not apply because the distribution of warrants was not a distribution of "solely stock or securities," and because the sale of the Shorewood stock to warrant holders was not a distribution with respect to Shorewood stock, as required by Section 355(a)(1)(A) (Pet. App. A-9 to A-12, A-17).

2. Contrary to petitioners' argument (Pet. 5-8), the decision below does not conflict with either *Commissioner* v. *Gordon*, 382 F. 2d 499 (2d Cir. 1967), rev'd, 391 U.S. 83 (1968), or *Palmer* v. *Commissioner*, 302 U.S. 63 (1937). *Gordon* arose out of an attempt to bring a spin-off within Section 355 where the distribution to shareholders was made in more than one step. There, as here, a corporation distributed short-term transferable stock rights to its shareholders, followed by a sale of stock at a bargain price, pursuant to the terms of the rights. The offering was made in two stages, the first in 1961 of 57.3% of the stock of the controlled corporation, and the balance in 1963. The Tax Court originally held that Section 355 was applicable, and the exercise of the rights was not a taxable event to the recipients (45 T.C. 71) (1965). On the Commissioner's appeals to both the Second and Ninth Circuits, the Second Circuit affirmed (382 F. 2d at 509), ruling that Section 355 does not require a one-step distribution and that the two distributions of warrants, followed each time by a sale of stock pursuant to the warrants, extending over a total of three years, satisfied Section 355 and were tax free. The Ninth Circuit disagreed, ruling (*Commissioner* v. *Baan*, 382 F. 2d 485, 496 (1967), aff'd, 391 U.S. 83 (1968)) that the

bargain sale of stock to the rights holders was not a "distribution" as that term is used in Section 355, that Section 355 required the transfer of control in a single "transaction" if not in a single step, and that these requirements had not been satisfied. In *Commissioner* v. *Gordon*, 391 U.S. 83 (1968), this Court resolved the conflict and upheld the Commissioner's position that the two distributions of rights, occurring over three years and without a binding commitment at the time of the first distribution as to when or if the second distribution would take place, could not be aggregated for purposes of meeting the "control" requirement (*id.* at 96).

Petitioners do not point to any specific respect in which the analysis of the court below conflicts with the analysis of the Second Circuit's *Gordon* opinion. At all events, since that decision was reversed by this Court, it can hardly be invoked as a precedent conflicting with the court below.

Nor does the decision below conflict with *Palmer* v. *Commissioner*, *supra*. In *Palmer*, the Court held that the mere issuance by a corporation to its shareholders of rights to subscribe for stock in another corporation was not a dividend until the sale or exercise of such rights. In *Commissioner* v. *Gordon*, *supra*, 391 U.S. at 89-90 n.4, the Court addressed *Palmer*, noting that, "[i]t has not, however, been authoritatively settled whether an issue of rights to purchase at less than fair market value itself constitutes a dividend, or the dividend occurs only on the actual purchase. In the present case this need not be decided." This case involves such an issuance of rights (warrants) to purchase stock at less than fair market value, *viz.*, the exact situation that this Court in *Gordon* said that *Palmer* did not cover. Moreover, the decision below is not only in harmony with the pertinent provisions of the Code,[3] but is in accord

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[3]Under Section 316(a) of the Internal Revenue Code of 1954 (26 U.S.C.), any distribution of property by a corporation to its shareholders, out of earnings and profits accumulated subsequent to March 1,

with *Baumer* v. *United States*, 580 F. 2d 863, 878-881 (5th Cir. 1978), and the views of numerous commentators.[4]

Finally, petitioners claim (Pet. 8-9) that the question presented has substantial administrative importance for tax planning. But this is only the second reported case we have been able to find involving a dispute as to the applicability of Section 355 to a multi-step "distribution." There is accordingly no basis for review by this Court.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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1913, is a dividend. When property is distributed in kind to a non-corporate shareholder, the amount of the distribution is the fair market value of the property at the time of distribution (see Section 301(b)(1)(A) of the Internal Revenue Code of 1954 (26 U.S.C.)). "Property," as defined in Section 317(a) of the Code, "means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." This broad definition of property includes stock warrants (options or rights to purchase stock). Indeed, the specific exclusion of rights to acquire stock of the distributing company would indicate that rights to purchase stock in *other* corporations are included in the term "property." *Baumer* v. *United States*, 580 F. 2d 863, 881 (5th Cir. 1978).

[4]See, *e.g.*, Jassy, *Dividend Treatment of Distributions of Options to Acquire Assets of the Distributing Corporation*, 34 Tax L. Rev. 607, 633-638, 644-645 (1979); Smith, *Rights Offerings of Portfolio Securities*, 26 Tax Law., 471, 480-481, 483 (1973); Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer* v. *Commissioner*, 23 Tax L. Rev. 129, 131-132, 152-153 (1968); and Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 Yale L.J. 1016, 1024 (1957).